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ANALYST INTERVIEW

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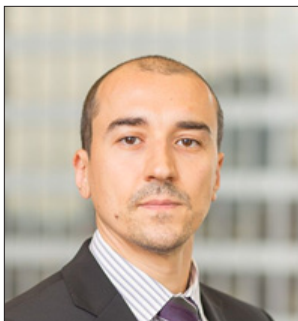
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Challenging Economic Backdrop Hinders Growth for Canada Banks

MIKE RIZVANOVIC — VERITAS INVESTMENT RESEARCH CORPORATION



MIKE RIZVANOVIC is a Lead Analyst for financial services at Veritas Investment Research Corporation. Before joining the company in 2015, Mr. Rizvanovic spent two years in Deloitte's M&A financial advisory practice covering nonbank financials, and prior to that, six years at CIBC World Markets as an Equity Research Associate covering the Canadian banks and life insurers. Mr. Rizvanovic earned his MBA from the Schulich School of Business and is a CFA charterholder.

SECTOR — BANKING

(AGT801) TWST: What do you cover at Veritas?

Mr. Rizvanovic: I cover the big six Canadian banks, as in the **Bank of Montreal** (NYSE:BMO), **Scotiabank** (NYSE:BNS), **CIBC** (NYSE:CM), **National Bank** (OTCMKTS:NTIOF), **Royal Bank** (NYSE:RY), **TD Bank** (NYSE:TD) and the smaller bank **Canadian Western Bank** (TSE:CWB). We also cover **Sun Life Financial** (NYSE:SLF) and **Manulife Financial** (NYSE:MFC), which are two of Canada's life insurance companies.

TWST: Can you talk about the banks as far as your outlook for the next 12 months?

Mr. Rizvanovic: Over the next 12 months, we think the outlook is a little bit challenging from a revenue growth perspective, and that is largely in the Canadian lending business. We have got significant debt levels on the consumer side which we think makes it much more difficult to maintain the growth rates that we have seen in previous years. The banks are now relying heavily on the cost side and have been relatively aggressive in the past six to 12 months with restructuring initiatives in order to limit expense inflation in the face of revenue growth moderation, especially on the consumer side.

It is going to be a challenging economic backdrop. The Canadian economy is not doing so well. We may not see a recession in 2017 or 2018, but certainly the numbers don't suggest that we are going to see robust growth moving forward. It is a challenging backdrop for

sure in Canada that is somewhat offset by the cost initiatives and the fact that some of the banks are diversified in terms of geography. **TD** has a very large U.S. lending business, and **BMO** does as well. **Royal Bank** has a large capital markets platform with 50% of

revenue generated in the U.S., and they have also have the recently-acquired **City National** private banking business in U.S., which they can grow. **CIBC** is looking to close its acquisition of **PrivateBancorp** (NASDAQ:PVTB), which provides a strong private banking platform in the U.S.

TWST: What trends are you monitoring most closely and why?

Mr. Rizvanovic: I am definitely looking at the credit side, as credit cycles in Canada typically range between seven and 10 years. We have not yet seen much in terms of credit deterioration in the current cycle outside of the oil and gas sector, which is a very small portion of the overall lending portfolio for Canadian banks. So we are really tracking the consumer side.

As I said, elevated debt levels in Canada do suggest that any sort of economic shock, given people's leverage, would be a major concern in terms of credit losses, but nothing has happened to date, and you really need a trigger for that to turn into an issue for the Canadian banks. The most obvious catalysts are higher unemployment or meaningfully higher interest rates, the latter of which I don't think is going to happen given Canada's struggling economy. With bond yields moving higher in Canada, the banks have started to move fixed mortgage up in order to offset higher funding costs, but I

Highlights

Mike Rizvanovic discusses his coverage of Canadian banks. He says for next 12 months the outlook is a bit challenging from a revenue growth perspective because of the struggling economic backdrop. He says what is underappreciated from a global perspective is that Canadian banks sit in a different environment on the regulatory front and have been resilient in the last couple of years. However, while Canadian banks are world-class and a good investment versus banks in Europe and the U.S., Mr. Rizvanovic says banks in Canada are valued for that differential and are not cheap.

Companies discussed: Bank of Montreal (USA) (NYSE:BMO); Bank of Nova Scotia (NYSE:BNS); Canadian Imperial Bank of Commerce (USA) (NYSE:CM); National Bank of Canada (OTCMKTS:NTIOF); Royal Bank of Canada (NYSE:RY); Toronto-Dominion Bank (NYSE:TD); Canadian Western Bank (TSE:CWB); Sun Life Financial (NYSE:SLF); Manulife Financial Corporation (USA) (NYSE:MFC); PrivateBancorp (NASDAQ:PVTB) and General Electric Company (NYSE:GE).

am not expecting the **Bank of Canada** to move the short end of the curve higher. And so we should see divergence with U.S. monetary policy at least over the near term.

TWST: The government in the U.S. is finely regulating the banks, as well as we are seeing signs of a rising interest rate. What is happening in Canada?

Mr. Rizvanovic: In Canada, regulators are looking to finalize where the Canadian banks should settle on regular capital ratios. We are not quite there yet. The Canadian banks are generally thought to be well-capitalized, although some global peers, such as the Nordic and Australian banks in particular, carry much higher levels of capital.

It's important to note that in Canada, we've got roughly half of total residential mortgages being insured by the government through the Canada Mortgage and Housing Corporation, the CMHC. So even though the Canadian banks have slightly lower capital levels on a global basis, that does not mean that they are undercapitalized. And note that the Canadian banks tend to generate anywhere between 10 to 15 basis points in regulatory capital each quarter. So the regime in Canada is one in which the regulator is looking to find the right balance.

Right now CET1 capital ratios for the large Canadian banks range between 10% and 11%. I don't believe that regulators will do anything that will dramatically impact the banks from a capital perspective. So when they make changes, they tend to do it not on a retroactive but rather on a go-forward basis.

TWST: How is the energy sector impacting the banks, and also where do you see the most loan growth happening as far as business sectors in Canada?

Mr. Rizvanovic: Oil and gas, as I mentioned earlier, is a very small portion of the portfolio; it ranges anywhere from 1% to 3% of total loans for the big six Canadian banks on average. That is not something that is going to move the needle materially. It is really the only area in the loan portfolio in Canada that has recently experienced sizable loan losses. But that has subsided at the aggregate level over the past couple of quarters.

Other areas for lending growth are relatively broad-based in Canada. Business lending has been very strong for the Canadian banks. There isn't really any one sector that has driven the majority of that. It really is broad-based and speaks to the diversification of the loan book on the business side.

TWST: Can you speak to specific banks that you are in a "buy" mode about and which ones you would caution investors to maybe steer clear of?

Mr. Rizvanovic: CIBC is our topic pick, and that really is a function of the improvement that it has had in its Canadian lending business. It is a very Canada-centric bank that does not have too much exposure outside of the country. For them, it has really been a situation where they have had a lot of catch-up room after lagging peers for such a long time. In the past couple of years, the results have been certainly much stronger than peers in Canada. We think

there is a bit more to that story. It is our top "buy." Despite our caution on the Canadian lending business, we do think that **CIBC** can get further market share gains.

TD we like as well, mostly because of its U.S. business where it is really performing well, offsetting a lot of the weakness in its Canadian lending business. In the U.S. it tends to outperform peers that it competes with in all regions within its existing footprint. It is a very good operator in the U.S. Interest rates are looking to move up further in the U.S., and that should lead to some net interest margin expansion in **TD's** U.S. business, which accounts for roughly 30% of the bank's consolidated earnings.

One we are more cautious on would be **Canadian Western Bank**. It is much smaller than any of the big six banks and doesn't have very much revenue diversification. Almost 90% of its total revenue net interest income, and it does not have a capital markets platform. That makes **CWB** much more dependent on what happens with interest rates, as the low-rate environment negatively impacts their net interest margins. And their margin has in fact been declining over the past several years. That is a much bigger issue than it would be for any other large Canadian bank. **CWB** has been trying to offset that with double-digit growth in lending, which we don't believe is sustainable. We don't see the bank's ROE moving much above the 10% level over the next couple of years.

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1-Year Daily Chart of Canadian Imperial Bank of Commerce



Chart provided by www.BigCharts.com

TWST: Are the banks purposefully diversifying in several ways in order to be more competitive? Also, you talked about the need to be perhaps diversified geographically. Can you describe how they would be doing that operationally? Is M&A happening or do they use some other means?

Mr. Rizvanovic: Definitely there is a diversification strategy that has really been driven by the fact that the lending market in Canada has become mature. The large banks have an oligopoly in Canada and control the vast majority of the prime lending market. But there is little growth ahead as the Canadian

consumer is pretty much tapped out and the housing market appears overvalued, especially in Vancouver and Toronto. Our debt levels are very, very elevated relative to where they have been historically; that has been driven largely by declining interest rates, which makes carrying debt ever cheaper. So diversification outside of Canadian lending is necessary as the banks come to the realization that they just cannot grow in Canada as robustly as in the past.

We are not going to have mortgage credit in Canada expanding at 6% to 7% in perpetuity, especially given where we are today and the fact that interest rates probably don't have another significant leg. So if you are staring at a mature market, which represents the vast majority of your business, to me the best strategy is what a lot of them are doing, and that is to look to continue growing outside of Canada. Some of the Canadian banks are small players in the U.S., so there is lots of room to grow.

That is something that I think **TD** will continue to do and **BMO** as well. **BMO** has really scaled up with the purchase of **GE's** (NYSE:GE) transportation finance business. That has been a boon to them. They are looking to scale up in the U.S. further. In **Royal Bank's** case, they will keep investing in their private banking platform; their **City National** franchise is a very prolific private banker in the U.S.

CIBC is doing the same thing as in trying to purchase **PrivateBancorp** in the U.S. to get a better cross-sell for Canadian and U.S. clients. **PrivateBancorp** would really help to add a lot of product that they simply just don't have in terms of the capabilities. Right now the shareholder vote has been postponed by **PrivateBancorp**, as the shares have run up quite significantly since the U.S. election. It looks as if **CIBC** may be forced to sweeten their offer. So acquisitions certainly do play a role in that diversification strategy. It is not all organic growth.

TWST: Can you say some words as you compare and contrast the Canadian banks that you cover to perhaps the other international banks in the U.S. and elsewhere in the world?

Mr. Rizvanovic: It is important to note that Canada's banking structure is very unique. We do have, as I mentioned, about half of existing mortgage debt in Canada insured by the government. It really provides the banks with a huge benefit. What it does is it allows them to carry less capital. As I mentioned, when you look at capital ratios on a Basel III basis and compare the Canadian banks against some of their international peers they are less well-capitalized, but at the same time you have to consider the fact that those peers do have that backstop from the government. Our banks here are very protected, and that oligopoly position is not going to change.

The Canadian banks have a significant distribution advantage, so you are not going to see any foreign bank come into Canada and be able to make any sort of significant progress. Those that do make their way into Canada tend to focus on very niche areas that the Canadian banks might not cater to. Even if you look at the fintech firms that are making a little bit of noise in Canada on the lending

side, they are largely trying to find a niche by lending to smaller firms.

The large Canadian banks have well-established relationships with the larger corporate accounts which are much more profitable to them because they can sell periphery services and capital markets-type services. I don't think that is going to change. The Canadian banks are very, very dominant here, and the structure is very different than in the U.S. where you have almost 7,000 smaller lenders.

TWST: Looking at your coverage right now, what do you think is either the most surprising aspect to you or the most underappreciated?

Mr. Rizvanovic: The most underappreciated probably from a global perspective is that the banks do sit in a very, very different environment at least from the regulatory front. There has been quite a bit of divergence in how regulators have treated their banks across different jurisdictions. In Canada the large banks are viewed somewhat as national champions. So I think that is maybe a bit underappreciated in that our regulators will consult with the banks before they make any sort of changes that impact them in any meaningful way; it is always a very gradual-type approach. They don't want to rock the boat and hurt the sector. That is probably not a structure that you see anywhere else in the world. There has been a lot of bank bashing post-financial crisis in the U.S., and we really haven't seen that in Canada in any sort of material way.

"The most underappreciated probably from a global perspective is that the banks do sit in a very, very different environment at least from the regulatory front. There has been quite a bit of divergence in how regulators have treated their banks across different jurisdictions."

1-Year Daily Chart of Toronto Dominion Bank



Chart provided by www.BigCharts.com

With respect to what has been surprising, perhaps one can point to the resiliency of the Canadian banks in the last couple of years. Despite a tough economic climate in Canada, the Canadian banks have not experienced any major credit losses. That has been a bit surprising to me for sure. If you look at the Alberta economy, where the employment rate is now basically double where it was about a year and a half ago, loan losses are only slowly moving higher at this point in time. I am not sure how much longer that can last. If anything it just heightens the risk that if we do get an economic shock in Canada, you could see losses spike significantly. That has been surprising to a lot of investors.

TWST: Overall, what is your advice in terms of potential investors who are looking at the Canadian banks?

Mr. Rizvanovic: Canadian banks are definitely world-class and probably a good relative investment versus maybe the banks in other jurisdictions such as Europe and in the U.S. However, banks in Canada are valued for that differential. I don't think they are cheap. They are fully priced in, and for a bank paying a dividend yield in the 4% range, it is not a bad place to invest, but they are certainly not going to have anywhere near the growth that they have been able to obtain in the past 15 years with much of that fueled by a housing market boom.

I expect further deceleration in EPS growth, even if we don't get an economic shock. The Canadian banks are a lot bigger today than they were 15 years ago, so that also suggests that they cannot grow as robustly as in the past. They should definitely not be looked at as growth stocks. So a 4% dividend yield is probably one of the biggest reasons why you buy a Canadian bank stock; you don't buy it for capital appreciation, especially at current valuation multiples.

TWST: Is there anything else you wanted to add that

we haven't covered?

Mr. Rizvanovic: No, I think we've pretty much covered everything that matters.

TWST: Thank you. (KJL)

Note: Opinions and recommendations are as of 12/08/16.

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